Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of

Implementation of the Telecommunications Act of 1996 : **CC Docket No. 96-150**

Accounting Safeguards Under the Telecommunications Act of 1996

COMMENTS OF AT&T CORP ON SBC'S SECTION 272 COMPLIANCE BIENNIAL AUDIT REPORT

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Pursuant to the Commission's Public Notice in the above entitled matter,[1] AT&T Corp. ("AT&T") hereby submits its Comments on the Reports of Independent Accountants on Applying Agreed-Upon Procedures, prepared by Ernst & Young, LLP (the "Auditor") and filed on December 17, 2001 ("Audit Report" or the "audit") in connection with the first biennial section 272 audit of the SBC companies.

INTRODUCTION AND SUMMARY

The section 272 audit process is in drastic need of resuscitation. Audit standards and procedures remain woefully incomplete and, in large part, are not even disclosed. As a result, the auditors fail to conduct the proper inquiries and gather the evidence necessary to test actual compliance with the key section 272 requirements. Both commenting parties and the Commission are severely compromised in their abilities to analyze and comment upon the

[1] *See* Public Notice, *In the Matter of Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket 96-150, (Oct. 31, 2002).

limited inquiries that are conducted. And the process has become subject to such inexcusable delay that the audit's ability to serve as an effective enforcement mechanism has been seriously undermined. As SBC's conduct in this proceeding well illustrates, an audited carrier can delay the release of the audit report by a year or more with the flimsiest claim of "confidentiality" – even a claim that is virtually identical to one that the Commission has just rejected and that in fact represents an effort to hide damaging findings from the public and regulators. The debilitating effects of delay are only compounded when the Commission fails to impose penalties, or even to issue an order, long after the audit results are reported and clear violations are established.

This first section 272 audit of the SBC Companies confirms both the "critical" importance of enforcement of the "broad section 272(d) audit requirement" in "promoting competition in the market for in-region interLATA telecommunications,"[2] and the practical reality that the Bells will treat future section 272 audits – and the nondiscrimination and cross-subsidization obligations that such audits were meant rigorously to test – as jokes unless the Commission overhauls the audit process and, through action, not words, makes clear that it will strictly and swiftly punish any discrimination and cross-subsidization uncovered by an audit. The audit period for SBC ended in July *2001*, and the performance data used to evaluate SBC's compliance with its section 272 nondiscrimination duties ran only through March 2001. But the audit report was not released in unredacted form until October, 2002, a delay that SBC triggered with a claim that nearly half of the audit report contained "confidential" material – an entirely frivolous claim nearly identical to the one that the Commission already rejected with respect to Verizon in January 2002. In reality, SBC was plainly aware that the audit report contained

[2] Order, *In the Matter of Accounting Safeguards Under the Telecommunications Act of 1996*, ¶ 12, CC Docket 96-150, (Jan. 10, 2002) ("*Verizon Audit Data Disclosure Order*").

damaging findings – including performance data that, as described herein, clearly revealed discriminatory performance – that it was not complying with section 272. It sought to forever withhold the embarrassing performance data from public view, based on its astonishing claim that such performance data was "irrelevant" and could have "unnecessary negative consequences for SBC," including what SBC called "unjustified concern" by competing providers and regulators.[3] Through these specious confidentiality claims, SBC was able to cause months of delay in the audit process.

As detailed below, the SBC auditors failed to conduct the proper inquiries and gather the evidence necessary to test fully SBC's compliance with its core section 272 obligations. The audit was conducted pursuant to incomplete standards and procedures that were developed without the benefit of public comment and that have never been publicly disclosed.

A comparison of the audit report with the "General Standard Procedures" that the auditors were to employ (a copy of which AT&T requested and only recently obtained from the Commission's staff), reveals many instances in which the auditors did not comply with the General Standard Procedures. In many other respects, the audit reports fail even to disclose the scope of the audit inquiries. And many of the audit inquiries that are described rely upon patently inadequate measurements that are likely to miss or mask discrimination. The auditors also violated established sampling methodologies and failed to follow the requirement in the General Standard Procedures to examine all of the elements in some populations. In short, even if the auditors' report had given SBC a clean bill of health, there would be no possible basis to conclude that SBC complied with its Section 272 obligations during the audit period.

[3] Memorandum Opinion and Order, *In the Matter of Accounting Safeguards Under the Telecommunications Act of 1996: Section 272(d) Biennial Audit Procedures*, CC Docket No. 96-150, ¶ 4 n.9, (rel. Sept. 5, 2002) ("*SBC Audit Data Disclosure Order*").

The reality, however, is that although the auditors' inquiries were far too narrow to provide a complete picture of SBC's post-entry behavior, they shed enough light on SBC's practices to confirm pervasive discrimination and other anticompetitive conduct in clear violation of Section 272. For example, with regard to completion of DS0 orders by the required due date, the performance data that SBC sought to keep secret show that SBC's affiliates received better performance in *each* of the last seven months – and the largest differences were in the last two months reported, confirming that SBC's performance was decreasing. The data also show that SBC's return of firm order confirmations on DS1 and DS3 facilities were longer for SBC's rivals than for its affiliates in *all* 18 of the instances where the measure employed showed a performance difference. Likewise, for restoration of trouble, by both measures SBC's competitors virtually always suffered longer delays than SBC's affiliates. For other measurements too, SBC provided better service to its affiliates than to competing providers. The auditor's report likewise details numerous violations by SBC of its Section 272 obligations to, *inter alia*, operate independently from its affiliates, to keep separate books, records and accounts, to maintain separate employees, and to conduct affiliate transactions on an arms-length basis.

If the Section 272 requirements are to have any deterrent effect at all, the Commission must respond to these violations with swift and severe penalties. With respect to the first Section 272 BOC audit conducted for Verizon, the Commission has yet to act, despite significant findings by the auditors (even using flawed procedures) that establish beyond serious dispute that Verizon violated section 272 in many respects.[4] This delay undercuts and contradicts not only the Commission's general emphasis on enforcement but its prior vigorous endorsements of the importance of Section 272 generally and of the biennial audits in particular (*see infra* Part II).

[4] *See* Comments of AT&T Corp. on Verizon's Section 272 Compliance Biennial Audit Report, CC Docket No. 96-150 (filed Apr. 8, 2002) ("*AT&T 272 Verizon Audit Comments*").

Thus, the Commission should act promptly and decisively in this proceeding. Even the limited audit procedures disclosed numerous and pervasive violations by SBC. SBC complains that the audit results are not statistically significant, but, as demonstrated in the attached declaration of statistician Dr. Robert Bell, the findings regarding many of the most egregious violations plainly are significant and representative of SBC's standard operating practices.

If nothing else, SBC's attempt to use the superficiality of the auditors' inquiries to deflect attention from the Section 272 violations that those concededly inadequate audits were nonetheless able to uncover must be viewed as a concession by SBC both that SBC's own performance must be re-audited, and, more generally, that the Section 272 audit process must be radically reformed. To revive the biennial audit process, the Commission should ensure that i) the substantial delays in the release of the BOC audits are ended, ii) the audit standards and procedures are significantly strengthened, and iii) violations are swiftly punished.

With respect to the audit standards and procedures in particular, the Commission should take immediate action to implement standards and procedures that require specific, detailed inquiries that are consistent with sound auditing and statistical practices and sufficient to provide a complete and meaningful evaluation of a BOC's compliance with its Section 272 obligations. In this regard, the Commission should complete the process it initiated nearly six years ago, *see* Public Notice, *Proposed Model For Preliminary Biennial Audit Requirements Under Section 272*, AAD No. 97-83, 12 FCC Rcd. 13132 (1997) ("*Proposed Biennial Audit Model*"). In particular, the Commission should establish auditing standards and procedures that require the auditors to evaluate a number of specific performance and other criteria, using specific sampling/auditing criteria, and to fully disclose the scope of their inquiries, their collection, sampling and analysis methodologies, and any failures by the BOC to maintain, collect and

provide requested data (which the Commission should penalize with a presumption of noncompliance for any affected measurements).

Because the Section 272 audit process has so clearly broken down, it is of paramount importance to consumers and competition that the Commission take a hard line here and confirm that it will not tolerate Section 272 violations and that future Section 272 audits must be promptly completed, much more rigorous, comprehensive and well-documented.

I. BACKGROUND

A. Section 272 And The Commission's Implementing Rules.

To supply Bell Operating Companies ("BOCs") with incentives to comply with their market-opening obligations under the Telecommunications Act of 1996, Congress provided that, upon meeting all of the requirements of section 271, BOCs could offer the interLATA services that they have always been barred from providing by virtue of their bottleneck control over local facilities. 47 U.S.C. § 271. But Congress recognized that, even after full implementation of section 271's competitive checklist, local markets would not quickly become robustly competitive and that BOCs would still retain both the incentive and the ability to discriminate against competing providers of telecommunications services. *Non-Accounting Safeguards Order* ¶ 9.[5]

Section 272 was enacted to bridge the chasm between the "fundamental postulate underlying modern telecommunications law" – that the Bell Operating Companies ("BOCs") will "have both the incentive and ability to discriminate against competitors in incumbent LECs' retail markets" until their monopoly local telephone markets become fully competitive,

[5] First Report and Order and Further Notice of Proposed Rulemaking, *Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended*, 11 FCC Rcd. 21905 (1996) ("*Non-Accounting Safeguards Order*").

SBC/Ameritech Merger Order ¶¶ 12, 190 ("This incentive exists in all retail markets in which they participate") – and the Section 271 command that BOCs be allowed to provide long distance services when their local markets are merely *open* to competition.[6] Among other obligations, Section 272 requires a BOC, after obtaining Section 271 authority, to provide long distance and other services through independent and separate affiliates and to afford competing carriers the same treatment it provides to these affiliates. *See* 47 U.S.C. § 272; *Non-Accounting Safeguards Order*; *Accounting Safeguards Order*.[7] In particular, these separate affiliate and related requirements are "designed, in the absence of full competition in the local exchange marketplace, to prohibit anticompetitive discrimination and cost-shifting." *Non-Accounting Safeguards Order* ¶ 9.

But a nonstructural anti-discrimination rule can do little to combat bottleneck monopoly abuse unless it can be, and is, effectively enforced, and Congress was well aware of the long history of BOC evasion of such rules. That is why Congress expressly provided both for periodic, in-depth, independent audits of each BOC's post-entry conduct and for penalties in the event of misconduct, including revocation of the BOC's Section 271 authority. See 47 U.S.C. §§ 272(d); 271(d)(6). The Section 272 audit is thus of paramount importance. As the Commission has concluded, "the broad section 272(d) audit requirement and the mandatory public comment process are critical components in ensuring compliance with the separate affiliate safeguards and promoting competition in the market for in-region interLATA

[6] Memorandum Opinion And Order, *Applications Of Ameritech Corp., Transferor, And SBC Communications Inc., Transferee, For Consent To Transfer Control Of Corporations*, 14 FCC Rcd. 14712 (1999) ("*SBC/Ameritech Merger Order*").

[7] Report and Order, *Accounting Safeguards Under the Telecommunications Act of 1996*, 11 FCC Rcd 17359 (1996) ("*Accounting Safeguards Order*").

telecommunications." *Verizon Audit Data Disclosure Order* ¶ 12. Even BOCs have recognized that the Act requires biennial audits that "fully test[]" BOC compliance with section 272.[8]

1. The BOCs' Anti-Discrimination Obligations. Section 272 includes a variety of nondiscrimination obligations, including a generalized and "flat prohibition against discrimination," *Non-Accounting Safeguards Order* ¶ 195 (*citing* 47 U.S.C. § 272(c)(1)), as well as more specific duties to ensure, for example, that competitors' "requests" for services, facilities, or information (among other things) are fulfilled as quickly and on the same terms as requests by the BOCs' 272 affiliates. 47 U.S.C. § 272(e); *see Non-Accounting Safeguards Order* ¶¶ 237-71. With respect to the general duty, section 272(c)(1) provides that a BOC "may not discriminate" between its section 272 affiliate and "any other entity in the provision or procurement of goods, services, facilities, and information, or in the establishment of standards." 47 U.S.C. § 272(c)(1). As the Commission has explained, section 272(c) establishes an "unqualified prohibition against discrimination by a BOC in its dealings with its section 272 affiliate and unaffiliated entities." *Non-Accounting Safeguards Order* ¶ 197. This antidiscrimination duty is to be applied using a "stringent standard." *Id.* Section 272(e) adds a number of many specific nondiscrimination requirements, including prohibitions on discrimination with respect to i) the fulfillment of requests for telephone exchange and exchange access (§ 272(e)(1)), ii) the provision of facilities, services, or information concerning exchange access (§ 272(e)(2)), iii) the amount charged or imputed for access to telephone exchange and exchange access (§ 272(e)(3)), or iv) the provision of interLATA or intraLATA facilities or services (§ 272(e)(4)).

[8] *See* Opp. of Bell Atlantic to AT&T's Motion for Expedited Decision, at 7, CC Docket 98-121 (filed June 5, 2000).

All of these provisions were intended to prevent a BOC from using "its control of local exchange facilities to discriminate against its affiliate's rivals," and thereby, to ensure that "unaffiliated entities receive the same treatment as the BOC gives to its section 272 affiliate." *Non-Accounting Safeguards Order* ¶¶ 194, 204; *see id.* ¶ 206 (BOCs should "provide efficient service to rivals of its section 272 affiliate," and Commission's rules should therefore "require[] that potential competitors do not receive less favorable prices or terms, or less advantageous services from the BOC that its separate affiliate"); *BA-NY Order* ¶ 402 (section 272 seeks to "ensure that BOCs compete on a level playing field").[9]

2. Anti-Cross-Subsidization Provisions. As the Commission has stated, "if a BOC charges other firms prices for inputs that are higher than the prices charged, or effectively charged, to the BOC's section 272 affiliate, then the BOC could create a 'price squeeze,'" in which "the BOC affiliate could lower its retail prices to reflect its unfair price advantage." *Non-Accounting Safeguards Order* ¶ 12; *see id.* ¶ 10. In recognition of the BOCs' incentives to engage in price squeezes and other improper cost misallocation, section 272 also includes a variety of provisions that help "prohibit . . . cost-shifting" and aid in detection and prevention of improper cross-subsidization. *Id.* ¶ 9. Thus, the BOCs' 272 affiliates must "operate independently" from the BOC, 47 U.S.C. § 272(b)(1), "maintain books, records, and accounts" that are "separate" from those of the BOC, *id.* § 272(b)(2), use "separate officers, directors, and employees" from the BOC, *id.* § 272(b)(3), may not obtain "credit under any arrangement" that provides a creditor with "recourse to the assets" of the BOC, *id.* § 272(b)(4), and must "conduct all transactions" with the BOC "on an arm's length basis with any such transactions reduced to

[9] Memorandum Opinion and Order, *Application by Bell Atlantic-New York For Authorization Under Section 271 In The State Of New York*, 15 FCC Rcd. 3953, ¶ 402 (1999) ("*BA-NY Order*").

writing and available for public inspection." *Id.* § 272(b)(5). Moreover, the BOC must "account for all transactions" with its section 272 affiliates in accordance with proper accounting principles. *Id.* § 272(c)(2). All of these provisions, and the Commission's rules implementing them, help to create a "heightened transparency" between the BOC and its affiliates so that cross-subsidies can be deterred and detected. *E.g.*, *Non-Accounting Safeguards Order* ¶¶ 158-59, 163; *Accounting Safeguards Order* ¶ 202.

The Commission has adopted a host of rules to implement these provisions and to protect "ratepayers, consumers, and competitors against the effects of potential improper cost allocation." *Accounting Safeguards Order* ¶ 4. For example, the Commission prohibited the same personnel from performing "operations, installation, and maintenance [OI&M] services" on both the BOC's facilities and those of the section 272 affiliate. *Non-Accounting Safeguards Order* ¶ 163. That was because any such joint activity would "create *substantial* opportunities for improper cost allocation." *Id.* (emphasis added). Likewise, the Commission adopted strict rules governing the transfer of assets and facilities, and required BOCs to use particular methodologies for the "valuation of affiliate services" that were "more likely to ensure" compliance with section 272's arm's length transaction requirements and "guard against cross-subsidization of competitive services." *Accounting Safeguards Order* ¶ 147. As these and other Commission rules make clear, section 272 plays a role of "crucial importance."[10]

[10] Indeed, section 272 is of such crucial importance (Memorandum Opinion And Order, *Application Of Ameritech Michigan Pursuant To Section 271,* 12 FCC Rcd. 20543, ¶ 346 (1997) ("*Ameritech Michigan Order*")) that the Commission has correctly held that its "findings regarding section 272 compliance constitute independent grounds for denying an application" pursuant to section 271. *BA-NY Order* ¶ 402 .

B. Role of the Section 272 Biennial Audit

The Act was designed to ensure that "durable competition in local markets" is maintained and that a BOC complies with the Act on an ongoing basis, and not merely at a "single moment in time." *Non-Accounting Safeguards Order* ¶ 333; *BA-NY Order* ¶ 453. Thus, Congress expressly provided in section 272(d) that a BOC operating a section 272 affiliate "shall obtain and pay for a joint Federal/State audit every two years" to determine whether the BOC has complied with section 272 and the Commission's rules, particularly with the "separate accounting requirements" in section 272(b).

As the Commission concluded in 1997, when it promulgated rules enforcing section 272:

> To obtain a fair assessment of BOC compliance [with section 272], *we must ensure adequate oversight* . . . . Commission guidance of the audit process is crucial to assuring that the accounting and structural safeguards are in place and functioning properly. Because of the critical nature of accounting safeguards in promoting competition in the telecommunications market and the *critical role* the biennial audit will play in ensuring that the safeguards are working, it is essential that we establish effective biennial audit rules at the outset.

Accounting Safeguards Order ¶ 197 (emphases added). In the Section 271 proceeding itself, the Commission is limited to making a predictive judgment about future compliance with section 272. *See Ameritech Michigan Order* ¶ 347. In reviewing SBC's section 271 application for Texas, the Commission's response to parties' concerns that SBC would not comply with section 272 was that the section 272 audit at issue here would provide a "*thorough and systematic* evaluation" of SBC's compliance with section 272. *SBC Texas Order* ¶ 409 (emphasis added).[11] The Commission's approval of SBC's application was thus based on its expectation that the

[11] Memorandum Opinion and Order, *Application by SBC Communications Inc., et al Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in Texas*, 15 FCC Rcd. 18354 (2000) ("*SBC Texas Order*").

biennial audits at issue here would result in stringent post-entry oversight of SBC's section 272 compliance. *Id.*; *see also BA-NY Order* ¶ 416 & n.1284.

Further, the audit can also play a vital role in regulation of the BOCs at the state level, as demonstrated by the comments filed by numerous state commissions in the Commission's proceeding on the sunset of section 272 requirements. The Missouri PSC, for example, reported that "without the section 272 audit process, there is no way to detect and deter discrimination and anti-competitive behavior." Missouri PSC, WC Docket 02-112, at 4; *see* Wash UTC, WC Docket 02-112, at 3 ("maintaining a separate affiliate makes the audit process easier and provides more transparency to the transactions to be audited"); PA PUC, WC Docket 02-112, at 4 ("audits can produce useful information for policymakers such as the PUC"); Texas PUC, WC Docket 02-112, at 8-9. And more generally, the PA PUC states that the collapse of separate affiliate requirements would "perpetuate[] what appears to be a continual reduction in available information." PA PUC, WC Docket 02-112, at 4. As these statements demonstrate, the Section 272 audit – when properly conducted – is a primary means by which the Commission and state regulators can test compliance with the requirements of 272 and other pro-competitive safeguards.

C. History of this Proceeding

1. Development of Audit Standards. Recognizing that an audit is only as good as the procedures used to conduct it, the Commission in 1997 "prescrib[ed] a specific report format" for the section 272 audits. *Accounting Safeguards Order* ¶¶ 185, 200. That same year, the Commission issued a public notice calling for comment on a model for the audit requirements proposed by the BOCs, *Proposed Biennial Audit Model*. AT&T and a number of other parties submitted comments and reply comments.

However, after delegating authority to a Federal/State joint audit team to review the conduct of the audit, *Accounting Safeguards Order* ¶ 198, the Commission never acted – at least in public – either with regard to the proposed model audit requirements or to the comments submitted. Instead, applicable audit standards and procedures were apparently developed without any further public input. The Audit Report repeatedly refers to a set of standards and procedures, *see General Standard Procedures for Biennial Audits Required Under Section 272 of the Communications Act of 1934, As Amended* ("*General Standard Procedures*"), but neither these standards and procedures nor any reasons supporting the adoption of these chosen standards were ever released publicly.

2. SBC's Post-Approval Audit. The Commission approved SBC's section 271 application for Texas in June 30, 2000, and its joint application for Oklahoma and Kansas on January 22, 2001, triggering the audit process. The Commission re-affirmed that it would carefully monitor SBC's future performance and that it would not hesitate to use its various enforcement powers "quickly and decisively" to ensure that SBC continued to comply with its obligations under the Act, including its duties under section 272 not to unduly favor the long distance services of its affiliates. *E.g., SBC Texas Order* ¶ 436; *BA-NY Order* ¶¶ 446-53; *see also Non-Accounting Safeguards Order* ¶ 347; *Accounting Safeguards Order* ¶ 197.

The audits were in fact conducted about two years ago, beginning in July 2000 (only weeks after SBC's affiliates were authorized to provide interLATA service in Texas) and ending in June, 2001. The period examined by the audit ended on July 9, 2001 – about a year and half ago. Even though the Commission sought to adopt rules that "prescribed a number of deadlines . . . to avoid prolonged delays in the audit's completion," *Non-Accounting Safeguards Order* ¶ 200, the audits were not publicly released in any form until January 28, 2002. Even then,

significant amounts of audit information had been redacted. By the Commission's count, SBC unilaterally determined to redact information from nearly *half* of the pages of the audit report, *SBC Audit Data Disclosure Order* ¶ 4 n.9, and SBC refused to revisit that decision even though the Commission ordered Verizon in January, 2002, to produce its audit report for New York in public form (*Verizon Audit Data Disclosure Order* ¶ 5). SBC claimed, among other things, that the performance data gathered by the audit "could have unnecessary negative consequences for SBC and may result in unnecessary and unjustified concern on the part of non-affiliated entities as well as other parties (*e.g.*, regulators)." *Id.* ¶ 25. SBC's redactions made it impossible to fully evaluate or verify the auditor's findings, and AT&T and others requested that the redacted information be disclosed, either publicly or pursuant to a protective order. *SBC Audit Data Disclosure Order* ¶¶ 6, 34.

After many months, the Commission released an order that rejected SBC's request for confidential treatment for the redacted information, and again concluded that the public must have access to sufficient information to assess whether a BOC is adhering to the section 272 structural, transactional, and nondiscrimination safeguards. *Id.* ¶¶ 8-9; *id.* ¶ 34 ("[t]he redacted information bears directly on SBC's compliance with" section 272's requirements). In particular, the Commission rejected SBC's argument on performance data, finding that "[e]mbarrassing facts, 'unnecessary negative consequences for SBC,' or 'unnecessary and unjustified concern' on the part of regulators do not constitute grounds for exempting information from disclosure." *Id.* ¶ 27. Because such performance data is directly relevant to SBC's compliance with section 272, the Commission stated that it was "concerned" that SBC now viewed such data as irrelevant. Indeed, SBC had specifically represented to the Commission during the section 271 process that it would report such data in a particular format,

and the Commission had relied on those representations in finding that SBC would comply with its section 272 obligations. *Id.* ¶ 28 (citing *SBC Texas Order* ¶ 412 n.1198). After the audit was released publicly on September 16, 2002, a public notice requesting comment was issued on October 31, 2002 – nearly one and half years after the close of the audit.

II. THE AUDITS WERE DEFICIENT IN VIRTUALLY ALL CRITICAL AVENUES OF INQUIRY, YET STILL SHOW PERVASIVE VIOLATIONS OF SECTION 272.

The audit failed to conduct the proper inquiries and gather the necessary evidence to shed light on two key aspects of the critical issues to be investigated in a section 272 biennial audit: (1) is the BOC discriminating against its affiliate's competitors? and (2) are the BOC and the affiliate engaging in improper cost allocation? Even though determining the answers to these questions is the central purpose of a section 272 audit, this audit conducted only the most superficial analysis of nondiscrimination and cost misallocation that could not possibly permit the Commission to conclude that SBC is in fact complying with these critical obligations.[12]

Indeed, in many significant respects, the audit report fails to disclose even the scope of the audit inquiries and thus does not provide the answer to a more basic question: can the Commission, in fulfillment of its critical oversight role, *Accounting Safeguards Order* ¶ 197 ("Commission guidance of the audit process is crucial"), conclude that the audits were conducted in a manner so as to meaningfully assist the Commission in assessing SBC's compliance with section 272? This audit report is simply too sketchy to provide answers to that question as well. Thus, even if the information that is disclosed in the audit revealed that SBC and its affiliates had

[12] For example, as with Verizon's audit, this audit attempted to assess SBC's compliance with a number of section 272 obligations by using statistical sampling procedures where the audit procedures required an examination the entire population. Bell Decl. ¶¶ 12-23.

complied in every measured respect with section 272, the substantial gaps would prevent any audit finding that SBC, in fact, complied with its section 272 obligations during the audit period.

In fact, SBC's section 272 violations were so pervasive that even the inadequate audit that was conducted uncovered numerous serious violations, despite gaps that would preclude a finding of compliance. Indeed, the information that was discovered about SBC's affiliate practices are sufficiently egregious to require the Commission to impose an immediate and substantial remedy and penalty.

A. Anti-Discrimination Provisions

The audits demonstrate that SBC fails to comply with its nondiscrimination obligation to provide the "same treatment" to its section 272 affiliates and to unaffiliated competitors. *Non-Accounting Safeguards Order* ¶ 204. Pursuant to the *General Standard Procedures*, the audit purported to examine compliance with five "objectives" that relate to section 272 nondiscrimination obligations. Audit Report, App. A, at i-ii (Objectives VII-XI). However, there are significant flaws in the standards and procedures used to measure SBC's compliance with these objectives. Despite these flaws, the audit uncovered significant discrimination in favor of SBC's section 272 affiliates.

1. Even The Incomplete Performance Measures Used In The Audits Show Discrimination In Providing Special Access And Other Key Services Used To Provide InterLATA Services.

Under section 272(e)(1), a BOC must "fulfill" all "requests" by competing carriers for "exchange access" and other services under the same time standards that it provides to its section 272 affiliates. The Commission has emphasized that "the term 'requests' should be interpreted broadly" to include, at a minimum, "initial installation requests, subsequent requests for improvement, upgrades or modifications of service, or repair and maintenance of these services." *Non-Accounting Safeguards Order* ¶ 239. For these and any other "equivalent requests," the

Commission's rules require that "the response time a BOC provides to unaffiliated entities should be no greater than the response time it provides to itself or its affiliates." *Id.* ¶ 240. Furthermore, "the BOC must make available to unaffiliated entities information regarding the service intervals in which the BOCs provide service to themselves or their affiliates." *Id.* ¶ 242.

Pursuant to these rules, a BOC must rely on well-defined measurements to demonstrate that its performance in fulfilling competitors' "requests" is nondiscriminatory. Where robust measurements are used, the Commission and other interested parties can readily determine whether a BOC's affiliates are obtaining key inputs used in providing long distance, such as special access services, under more favorable conditions than unaffiliated carriers.[13] The audit for SBC's 272 affiliates, however, failed to use proper measurements, which could mask much discrimination. However, even the more limited data that was collected confirms that SBC's performance was consistently biased in favor of its affiliates.

i. The Measures Demonstrate Discriminatory Performance. The audit collected data for 7 measurements, 5 of which relate to exchange access and 2 of which relate to processing of PIC changes. Audit Report, Att A-6 and A-7.[14] Even though, as described below, the audit

[13] *See Non-Accounting Safeguards Order* ¶ 243 ("If competitors can easily obtain data about a BOC's compliance with section 272(e)(1), this increases the likelihood that potential discrimination can be detected and penalized; this, in turn, decreases the danger that discrimination will occur in the first place").

[14] PIC changes are the method by which a customer changes its primary long distance carrier. The BOC implements PIC changes, and it has obvious incentives to use the PIC change process in myriad ways to favor its long distance affiliates. This includes implementing PIC changes more quickly, but also includes additional forms of discrimination, like routinely placing a "PIC freeze" (a process which makes it more difficult for a customer to change its local carrier) on customers that select its affiliates' long distance services. The audits did not even purport to assess this type of discrimination, even though AT&T suspects that some BOCs are engaging in this very conduct. *See, e.g.,* Comments of AT&T Corp., *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 01-112, at 29-32 (detailing evidence and findings made by state commissions regarding BOC discrimination in PIC process) ("*AT&T Section 272 Sunset Comments*").

measurements were designed or were reported in a manner that would preclude any finding that SBC has complied with its nondiscrimination requirements, these limited measurements that SBC sought to shield from public review are nevertheless sufficient to demonstrate that performance was patently discriminatory.[15] For example, as Dr. Bell explains in detail, the data for the performance measure (No. 1) relating to the successful completion of orders by the desired due date show that non-affiliates received worse service *each* of the last seven months in Texas for DS0 facilities. Bell Dec. ¶ 46. Moreover, the largest differences in performance occur in the last two months – by February, 2001, SBC affiliates achieved about 93% on time, while competing providers received only 73% on time; in March, the difference widened from 91% for SBC affiliates and only *59%* for rivals. This pattern shows not merely discriminatory but also deteriorating service quality. *Id.*

Likewise, on the measure assessing firm order confirmations ("FOCs") for DS1 and DS3 facilities (No. 3), there was again consistent bias in favor of the 272 affiliates: it took longer for competing providers to receive FOCs in *all* 18 comparisons where there was a difference in the time period at which the 95th percentile measure was achieved. Bell Decl. ¶ 47. And, as described above, this measure does not reveal the full extent of the actual discrimination in performance: for half of the 18 comparisons where there was a performance difference between the SBC affiliates and competing providers, the affiliates did not achieve the 95th percentile until

[15] The data provided in this audit is yet another piece of evidence showing that the BOCs' provision of special access is both generally poor and discriminatory. This evidence includes the data collected in the first section 272 audit, which showed that Verizon uniformly provided better service to its 272 affiliates than to competitors. *See AT&T Verizon Audit Comments* at 16-22 & Bell Decl. Findings by various state commissions, including the New York PSC, the Minnesota PUC, and the Colorado PUC, also demonstrate that BOCs are impeding interLATA competition through poor and discriminatory special access provisioning. *See AT&T Section 272 Sunset Comments* at 25-29. And AT&T's own internal data also show that ILECs have consistently failed to provision special access orders in a timely manner, and that their performance has *decreased* over the last several years. *Id.* at 29.

the period entitled "Greater than 5 Days" (as opposed to the BOC affiliates' "1 Day"), which means that competing providers poor performance could have stretched on almost indefinitely. *Id.* On FOC timeliness, non-affiliates clearly and systematically suffered much worse service than SBC and its affiliates.

And Measure No. 4, which assessed the percentage of circuits restored within each successive one hour period, showed that SBC's affiliates received consistently preferential treatment for DS0 and DS1 orders. Bell Decl ¶¶ 51-66. For the related Measure No. 5, which gauged the meantime in hours for the duration of trouble reports, the metric used also clearly demonstrates discriminatory performance against non-SBC-affiliated providers. For DS1 facilities, the average duration of trouble was higher for competing carriers in *all* 11 months observed. Bell Decl. ¶ 68. As Dr. Bell explains, such poor performance is almost certainly statistically significant: considering the 9 months of SBC's performance in Texas for duration of troubles, the data reported showing uniform bias in favor of affiliates could only very rarely be expected to occur (*i.e.*, 1 time in 512) if competing providers were in fact receiving parity service. *Id.* Similar patterns of discriminatory performance were typical for DS0 facilities and for services provided in Oklahoma and Kansas. *Id.* ¶¶ 67, 69-70.

In its response to the audits, SBC (like Verizon before it) claims that a "stare and compare" approach is not reliable, particularly given the small volumes for certain of the audit measurements. Audit Report, Att. B-2 at 8. But as Dr. Bell explains, even though the audit measurements are too crude to permit use of basic statistical tests that would entirely avoid a "stare and compare" approach, SBC's claims that the measures do prove any discriminatory performance is belied by the consistent patterns of inferior service received by affiliates. Bell Decl. ¶ 45; *id.* ¶¶ 46-72. For these reasons, there is more than a firm basis to conclude that SBC

has systematically discriminated against the competitors of its Section 272 affiliates in providing services that these carriers need to compete.

And in all events, SBC's complaint that the performance data should be disregarded because of the small volumes of orders for the 272 affiliates is effectively a concession that the audit was inadequate and should be repeated. Neither SBC nor the auditor ever explains why these volumes are so small, and the obvious remedy is to collect data until there is a sufficient amount upon which to base a determination of SBC's compliance with section 272's nondiscrimination obligations.

ii. Flaws In the Design And Reporting of The Performance Measurements. The discriminatory performance revealed by the audit's performance measures is all the more significant because these violations were uncovered despite major deficiencies in the audit procedures and practice. The metrics used in the audit – while a modest improvement from the set of performance measures used in the prior section 272 audit to gauge Verizon's performance in New York – are still improperly designed. As discussed below and in Dr. Bell's declaration, the measurements used here often provided data in a manner that made it difficult to analyze whether SBC is providing nondiscriminatory access to special access and other key inputs, as required by section 272.

In particular, the performance measurements used here – like those used in the prior audit of Verizon – improperly excluded special access services provided by the BOC directly to retail customers, and instead included only access services that the SBC BOCs provided to the SBC affiliates. *See* Bell Decl. ¶¶ 42-43.[16] This omission is significant, because the BOC's practice may be for the section 272 affiliate to provide to retail customers only the interLATA service

[16] *See* Comments of WorldCom on Verizon Audit, WC Docket 96-150, at 7-8 (filed Apr. 8, 2001); AT&T *Ex Parte* Letter, at 3, WC Docket 96-150 (filed May 23, 2002).

component and for the BOC to provide the special access component. Because performance measurements for the latter instances are excluded, SBC and its affiliates would be able to provide substantially better service quality to their end users than competing carriers, without any effect on the performance measures used to assess SBC's special access provisioning. The BOCs have claimed that it is not possible to compare wholesale and retail data, but, as AT&T has explained, any process differences between the wholesale and retail provisioning of special access do not preclude comparison.[17] Indeed, the process differences may in fact *cause* the BOC to provide better service quality to retail customers.[18] The exclusion of SBC's special access provisioning directly to its retail customers permits SBC to hide discriminatory performance, and performance measures, like the ones used here, that exclude retail customers are not reliable proof that SBC is complying with its duties of nondiscrimination.[19]

This exclusion precludes any finding that the audits' performance measures could demonstrate that SBC was complying with its obligations throughout the audit period. Accordingly, to ensure that a more accurate and revealing picture of BOCs' special access performance is developed in future section 272 biennial audits, the Commission should, for all currently ongoing and future audits, require the BOCs to collect and the auditors to measure the BOCs special access performance using performance measures proposed by the Joint

[17] *E.g.*, Surrebuttal Testimony of Eileen Halloran on behalf of AT&T Communications of New England, Inc., at 3-11, *Investigation by the Department of Telecommunications and Energy on its own motion pursuant to G.L. c. 159, §§ 12 and 16, into Verizon New England Inc., d/b/a/ Verizon Massachusetts' provision of Special Access Services*, (Mass. Dep't of Telecomm. & Energy, filed Apr. 3, 2002).

[18] *Id.* at 12-18.

[19] Further, SBC has incorrectly claimed that the performance measures used here are unreliable because the sample sizes are small. However, a principal reason for the small sizes could be that the performance to retail customers is excluded.

Competitive Industry Group ("JCIG").[20] The JCIG special access performance measures consist of 11 separate metrics, which encompass ordering, provisioning, and maintenance and repair. The metrics are properly designed, and include appropriate and precise definitions and collect relevant data, including data that is properly disaggregated by type of services involved.[21] Significantly, state commissions – including the Public Utility Commission of Texas – are actively considering or have already adopted performance measures for special access that are similar to those proposed by the JCIG.[22]

Further, and as described by Dr. Bell, more than half – four of seven –of the performance measures are not reported in a manner required by the *General Standard Procedures*, but use different methods that could easily disguise discriminatory performance. Bell Decl. ¶¶ 24-34. For example, for several measures, the *General Standard Procedures* require reporting the percentage of services completed within a specified "successive . . . period" until 95% completion. *Id.* ¶ 25. However, instead of reporting percentages for each successive period, the auditors report only the single interval at which 95 percent of services had been completed. *Id.* As Dr. Bell explains, this discrepancy in the required method of reporting data could make it

[20] *See, e.g.*, Letter from JCIG, to The Honorable Michael K. Powell, *Performance Measures and Standards for Interstate Special Access Services*, CC Docket No. 01-321 (filed Jan. 22, 2002).

[21] *Id.; see also* Comments of AT&T Corp., *Performance Measures and Standards for Interstate Special Access Services*, CC Docket No. 01-321 (filed Jan. 22, 2002) ("*AT&T Special Access Comments*").

[22] *See, e.g.*, *AT&T Special Access Comments* at 14, 17, 21-22; Texas PUC Section 272 Sunset Comments, WC Docket No. 02-112, at 5-7 (July 25, 2002) (Docket No. 24515, *Petition for SWBT for Arbitration Regarding The Implementation of Special Access Performance Measures*). Nevertheless, the Commission should not hesitate to order use of the JCIG measures on a nationwide basis for interstate access services. As AT&T has described, some state commissions are hesitant to act to require interstate special access performance measures, because they believe such matters are more appropriately handled by the Commission. *AT&T Special Access Comments* at 21-22

appear that the BOC and its affiliates received worse service, when in fact the exact opposite is true. *Id.* ¶¶ 25-34.

To illustrate the point, Dr. Bell compares the data reported to Performance Measure No. 2, which incorrectly assessed SBC's installation intervals, to Performance Measure No. 4, which properly gauged SBC's time to restore troubles. *Id.* ¶ 26-28. With respect to installation intervals, the Auditor should have reported data on the percentage of orders installed within 24 hours, then the percentage of orders installed within 2 days, continuing until the 95th percentile of installed orders was reached. *Id.* ¶ 26. However, the data simply show the single interval (*i.e.* days) at which the 95th percentile of orders in question was completed, which can conceal differences in performance. *Id.* If the data for trouble restoration had also been reported in this improper manner, for example, it would appear that SBC's affiliates received worse performance than competing providers. *Id.* ¶ 28. In fact, the data on its face shows that competing providers experienced substantially longer trouble restoration times than SBC's affiliates: just 35% of the troubles reported by competing providers were restored within one hour, but 61% of the troubles reported by SBC's affiliates were restored in that time. *Id.* As this example shows, the errors in this audit's reporting of the performance data can completely mask SBC's discriminatory performance.

In addition, some performance measures use such wide periods in which to report the 95% completion that the results are essentially useless. Bell Decl. ¶¶ 32-33. For example, Performance Measurement No. 6 purports to assess whether SBC completes PIC changes in a timely fashion by measuring the percentages of PIC changes completed within successive six hour periods. *Id.* Because the six hour period is such a wide range relative to the time at which 95% completion is attained, the reporting format could easily conceal discriminatory

performance. *Id.* To illustrate the point, Dr. Bell includes a figure demonstrating how the performance measure used would show that both competing providers and SBC affiliates had PIC changes implemented in the same six hour period, even though SBC's actual performance clearly discriminates against competing providers. *Id.*, Figure 1.

The audit report was also deficient because it failed to report basic statistical information or used terminology that has no generally accepted meaning in statistics. As Dr. Bell explains, the audit report pervasively failed to include information such as sample sizes, standard deviations, and a measure of uncertainty in conjunction with the performance measurements. Bell Decl. ¶ 38. Such information is critical for interested parties, including regulators, to evaluate the performance data. In addition, the audit report chooses to measure differences in performance through the use of what it calls a "variance" figure, even though it has no connection to the term variance commonly used in statistics. *See* Bell Decl. ¶¶ 37-41. Moreover, as Dr. Bell explains, the use of this variance figure is so riddled with errors that the figure is often at best meaningless and at worst affirmatively misleading. *Id.*[23]

B. Anti-Cross-Subsidization Provisions.

Section 272 contains numerous "provisions that are intended to deter cross-subsidization by the BOC" and, as the Commission has stated, "we must know whether the BOCs are

[23] In addition to poorly designed and reported performance measures, the audit did not properly assess SBC's compliance with the broad and general anti-discrimination provision in section 272(c)(1) that forbids discrimination in the "provision . . . of goods, services, facilities and information." For example, with regard to the section 272(c)(1) requirement that a BOC's sales representatives must inform new customers that other carriers provide long distance services, the *General Standard Procedures* required only that the auditors examine the marketing scripts from each call center and listen, for just a half-hour, to calls received by five randomly selected representatives at three randomly selected BOC call centers. *General Standard Procedures*, at 39-40. This recommended process could never adequately demonstrate SBC's compliance with these nondiscrimination requirements. To assess compliance would require, at a minimum, obtaining a statistically valid sample of calls – but the recommended process simply requires observations to occur over a given time period – and a short one at that.

complying with them." *Accounting Safeguards Order* ¶ 202. As a consequence, one of the critical purposes of the audit report is to "address whether the carrier has complied" with these anti-cross-subsidization provisions. *Id.* Here, the auditor failed specifically to address SBC's compliance with these parts of section 272, even though audits of other SBC companies have uncovered substantial evidence of cross-subsidization. Moreover, although the auditors examined "objectives" that purported to assess SBC's compliance with various structural requirements and cost allocation rules, in fact the audits suffered from a number of methodological defects. Nonetheless, even the superficial analysis that was conducted again revealed numerous violations.

1. The Audit Did Not Adequately Investigate Whether SBC Is Engaging in Cross-Subsidization.

The section 272 biennial audit is a critical tool that allows regulators and interested parties to collect and analyze information to determine SBC's compliance with the cost allocation rules that are designed to help prevent SBC from acting on its considerable incentives to engage in cross-subsidization and thereby to favor unfairly its affiliate's long distance operations at the expense of unaffiliated rivals. In this case, however, the scope of the audit inquiries was so limited and truncated that the audit provided little useful information regarding SBC's compliance.

The audit's failure to probe into the financial state and accounting records of SBC's section 272 affiliates represents a squandered opportunity, because in other contexts section 272's requirements and other regulatory audits have proven to be quite valuable to assessing a BOC's compliance with cost allocation rules. For example, in Texas, AT&T filed a complaint against SBC alleging improper cross-subsidization, and AT&T relied on section 272 disclosure

requirements to provide a factual basis for its claims.[24] Since SBC's entry into the interLATA market, AT&T has suspected that SBC has engaged in illegal cross-subsidization, based on, *inter alia*, the fact that SBC's long distance affiliate began offering intrastate long distance services at very low rates that are nearly equal to SBC's intrastate access charges and that therefore could not possibly allow the SBC affiliate to cover all of its costs.[25] As AT&T's experience in the Texas proceeding confirmed, section 272 reporting obligations can provide valuable insight into cross-subsidization claims. And while the auditor is not charged with determining the merits of AT&T's complaint, it is significant that the audit failed to make any additional inquiries or collect any additional information beyond what SBC had already disclosed that would shed light on the critical issue of SBC's compliance with cost allocation rules.

The inadequacy of this audit's inquiries is all the more obvious when compared to another regulatory audit of another SBC-owned BOC, Pacific Bell ("Pacific"), and SBCS, one of the same SBC section 272 affiliates audited here. The California PUC required an independent audit of Pacific, and the subsequently issued audit report – released and supplemented in

[24] *See* Second Amended Complaint of AT&T Communications of Texas, L.P., SOAH Docket No. 473-01-1558, Docket No. 23063 (Texas P.U.C. filed Dec. 5, 2001) ("*AT&T Price Squeeze Complaint*"). The PUC found that it did not have jurisdiction over the complaint – a finding that AT&T disputes. Regardless of whether the PUC is correct, AT&T still believes that the substance of its complaint has merit.

[25] Some of the plans offered by SBC's long distance affiliate offer long distance service for as low as 6 cents per minute for residential customers. *AT&T Price Squeeze Complaint* at 6-7. Yet the access charge that applies to a residential intrastate long distance call between SBC customers is about 5.67 cents per minute. *Id.* at 7. On such calls, SBC's affiliate gains net revenue of just a few tenths of a cent. However, it is evident that the affiliate's own operating expenses are significant, and along with the access cost, far exceed the retail rates that SBC's affiliate is charging. Based upon agreements that SBC has summarized as a result of its section 272 obligations, AT&T was able to estimate that the SBC long distance affiliate incurs billing and marketing expenses of at least 3.4 cents per minute. *Id.* at 8. Based on these pricing patterns, AT&T alleged that SBC's long distance rates were below-cost, result in a price squeeze, and are anti-competitive. *Id.*

February, May, and June, 2002, a few months after the SBC section 272 audit – contained dramatic findings of gross accounting misconduct involving Pacific and SBCS.[26] For example, this Pacific Audit Report found that Pacific "effectively transferred" its CPNI to SBC's centralized marketing services affiliate, but Pacific "has not been compensated for the transfer" of CPNI.[27] The tremendous value of this CPNI is self evident, because the BOC "is the only company with a nearly complete database of customers" as a result of its previous "exclusive franchise to provide local exchange in these areas."[28] As a result, the anticompetitive impact of such unpaid-for access to a BOC's CPNI cannot be overstated. The high customer acquisition costs faced by CLECs are significant barriers to their market entry and expansion. However, the Pacific Audit Report found that SBC's section 272 affiliate, SBCS, is able to obtain CPNI from affiliated BOCs without cost, giving it a substantial competitive advantage. The SBC section 272 biennial audit did not even attempt to assess SBC's conduct in Texas with respect to CPNI. *See* Audit Report, App. A, at 25.[29] Given the substantial allegations of SBC cost misallocation, the significant evidence of cross-subsidization and other misconduct uncovered in the Pacific

[26] *Regulatory Audit of Pacific Bell For The Years 1997, 1998, and 1999*, Overland Consulting (hereinafter "*Pacific Audit Report*"), issued Feb. 21, 2002 and supplemented May 8, 2002 and June 20, 2002. The *Pacific Audit Report* is available at www.cpuc.ca.gov/static/industry/telco/supplement+report+on+and+of+pacific+bell.htm.

[27] *Pacific Audit Report*, S12-1 (June 20, 2002).

[28] *Pacific Audit Report*, S12-7, ¶ 4 (June 20, 2002). As the Pacific Audit Report noted, Pacific's CPNI was "developed over several decades" and "funded by regulated telephone company customers."

[29] The *Pacific Audit Report* uncovered numerous additional evidence of cross-subsidization and cost misallocation, including (1) underreported net income by approximately $2 billion over the three-year period reviewed; (2) improper cross-subsidization through payments of $400 million in one year alone for the use of trade names that appear to be of limited value; and (3) a failure to establish proper internal accounting controls with respect to long distance and other affiliates. The section 272 audit at issue here again did not conduct investigations to determine if similar types of violations occurred in the audit period here for Texas.

audit, and the flawed investigation in the section 272 biennial audit, it is simply not possible to determine that SBC and its section 272 affiliates have properly accounted for all interaffiliate transactions.

2. The Audit Failed To Investigate Numerous Interaffiliate Transactions, But Nonetheless Uncovered Violations Of Disclosure Rules

Section 272(b)(5) requires an interLATA affiliate to "conduct all transactions with the Bell operating company of which it is an affiliate on an arm's length basis with any such transactions reduced to writing and available for public inspection." 47 U.S.C. § 272(b)(5). The Commission has found that these requirements include three distinct obligations: (1) the interLATA affiliate must provide, at a minimum, a detailed written description of assets transferred or services provided, and post the terms and conditions of the transaction on the company's home page on the Internet within 10 days of the transaction; (2) the descriptions "should be sufficiently detailed to allow [the Commission] to evaluate compliance with [the Commission's] accounting rules"; and (3) the descriptions must be made available for public inspection at the BOC's principal place of business, and must include a statement certifying the truth and accuracy of such disclosures. *Accounting Safeguards Order*, 11 FCC Rcd. at 17593-94.[30]

[30] Specifically, disclosures should include a description of the rates, terms and conditions of all transactions, as well as the frequency of recurring transactions and the approximate date of completed transactions. For asset transfers, the BOC should disclose the appropriate quantity and, if relevant, the quality of the transferred assets. For the affiliate transactions involving services, the BOC should disclose the number and type of personnel assigned to the project, the level of expertise of such personnel, any special equipment used to provide the service, the length of time required to complete the transaction, whether the hourly rate is a fully loaded rate, and whether or not that rate includes the cost of materials and all direct or indirect miscellaneous and overhead costs. *Second BellSouth Louisiana Order*, 13 FCC Rcd. 20599, 20790-95 (1998).

These disclosure rules help regulators and third parties ensure that BOCs and their section 272 affiliates comply with the other requirements of section 272 (and other regulatory requirements). However, SBC has apparently engaged in a campaign to hide certain interaffiliate transfers – normally subject to section 272 – from public view, as required by these disclosure requirements. Nothing in the audit here attempted to assess SBC's undisclosed affiliate transactions.

Specifically, SBC has created "shared services affiliates" that take over functions previously performed by the SBC BOCs and then provide those functions to the BOCs and all of their affiliates, including 272 affiliates. Thus, SBC's web site for section 272 disclosures reveals a number of publicly disclosed documents between SBC and SBC Management Services and SBC and SBC Services, Inc.[31] As a result of these transfers, these affiliates now apparently provide support services that the BOC typically provided. *See Pacific Bell Application* at 2 (requesting transfer of various support services, including IT and billing, real estate, procurement, human resources, and training). However, now that the affiliates provide these services to the BOC and other BOC affiliates, SBC does not disclose the terms of the services provided – thereby avoiding the disclosure requirements under section 272 and the Commission's rules. Thus, the SBC web site contains *no* affiliate transaction agreements between the shared services affiliates (SBCSI and SBC-MSI) and SBC's long distance and advanced services affiliates.

[31] *See* http://www.sbc.com/public_affairs/0,5931,1,00.html (search for "SBC Services, Inc" (39 documents) and "SBC Management Services Inc." (16 documents)) (search performed July, 2002). Further, SBC applied to the California PUC to transfer a number of support services to SBC Services. *See* Amendment to Pacific Bell's Application, *In the Matter of the Application of Pacific Bell To Lease Space and Transfer Assets to SBC Services, Inc.*, A.99-07-020 (C.P.U.C. filed Oct. 1999) ("*Pacific Bell Application*").

The audit not only did not even purport to investigate SBC's evasion of the rules, it affirmatively has aided SBC's obfuscation by refusing to disclose information regarding the services rendered to SBC's section 272 affiliates. As the audit report describes, the *General Standard Procedures* required that the auditors obtain and review a list of the services rendered to SBC's 272 affiliates by unaffiliated entities, the BOCs, and other SBC affiliates, which would include the shared service entities. Audit Report, App. A, at 2. Such a list would be important to monitor compliance with numerous section 272 requirements, including the disclosure requirements for affiliate transactions. While the auditors apparently obtained such a list, it was *not* provided as part of the audit report, despite the explicit request of the Joint Oversight Team. Audit Report, Att. B-1, at 1. As the JOT concluded, this list "is useful in the final analyses of the contents of the report. The American Institute of Public Accountants (AICPA) standards support this view." *Id.* The list was nevertheless not included, apparently because SBC objected to its inclusion in the audit report. *Id.* That objection should hardly be surprising, because withholding the list of the service provided to SBC's section 272 affiliates by these shared service organizations prevents interested parties from determining whether SBC is evading its disclosure responsibilities. There is simply no basis for withholding this list of services provided among SBC affiliates, and the audit report's refusal to disclose it reinforces that it cannot be relied upon to validate SBC's performance of its section 272 obligations.

Even though SBC appears to be dodging its disclosure obligations for affiliate transactions, for the transactions that it has publicly disclosed, the audit confirmed that SBC has repeatedly violated the Commission's disclosure rules. AT&T previously identified a number of violations of these requirements in the Texas Section 271 proceeding. *See Texas 271 Order* ¶ 405 (discussing declaration of AT&T witness Kargoll). The Commission expressed its

concern that SBC failed to post all of its transactions on the Internet and failed to provide sufficient detail of such transactions, and noted that SBC's "Internet postings will undergo a *thorough and systematic* review in the Section 272(d) biennial audit, which will ensure that any failure to post sufficient detail are identified in time for appropriate remedial action." *Id.* (emphasis added). That review has now occurred, and the audit has uncovered a continuing pattern of violations. For example, of the 450 agreements and pricing addendums, 25 –about 5 percent – were not posted on the Internet. *See* Audit Report, App. A, at 16, Attachment A-4. In addition, 17 other agreements were not available for public inspection. *Id.* And for those agreements that were posted and made available, the audit found that SBC did not post them in a timely manner consistent with the Commission's requirement. Thus, out of random sample of 100 agreements, between 3 and 15 percent were not posted in a timely manner, and in some cases the delays in posting extended over a month.[32]

C. The Commission Should Impose A Substantial And Immediate Penalty.

As a result of these pervasive and substantial violations of SBC's obligations under section 272, the Commission should immediately impose penalties that are sufficient to remedy the harm caused to SBC's competitors and to deter SBC (and other BOCs) from engaging in such discriminatory conduct in the future. The Commission has not hesitated to impose penalties in similar circumstances where a BOC violates core antidiscrimination requirements.[33]

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[32] Out of a random sample of 100, 3 were clearly not posted within ten days and 12 could not be verified because they were executed before 10/8/99 and SBC did not retain support.

[33] *See, e.g.*, *SBC Comm. Inc.,* File No. EB-00-IH-0326a (Feb. 25, 2002) (imposing forfeiture of $84,000 for violations of internet posting requirements); *Bell Atlantic-New York*, File No. EB-00-IH-0085 (March 9, 2000) (approving consent decree providing that Verizon will pay at least $3 million for lost or mishandled orders); *SBC Comm.,* File No. EB-00-IH-0030 (Jan. 18, 2002) (proposing $6 million forfeiture for failure to abide by pro-competitive merger condition); *SBC Comm.,* File No. EB-00-IH-0432 (May 29, 2001) (forfeiture of $88,000 where audit uncovered material violations of merger condition relating to performance data).

III. FUTURE AUDITS, INCLUDING A RE-AUDIT OF SBC, MUST BE PERFORMED UNDER DIFFERENT PROCEDURES

In addition to imposing proper penalties for SBC's pervasive violations of section 272, the Commission must also reinvigorate the biennial audit process to ensure that audits are released in a timely manner and that the standards and procedures employed will result in audits and audit reports that in fact allow the Commission, state commissions, and other interested parties to "have access to sufficient information to assess whether a BOC is adhering to the section 272 structural, transactional, and nondiscrimination safeguards." *Audit Data Disclosure Order* ¶ 7. A rigorous and thorough biennial audit provides significant benefits in detecting BOC discrimination and other anticompetitive conduct that poses a threat to competition on the level playing field that Congress intended. Additionally, rigorous biennial audits also serve a broader purpose: such audits could have a serious deterrent value, because BOCs will be more likely to follow their section 272 obligations if they expect a serious biennial audit. As the Commission has concluded, "[i]f competitors can easily obtain data about a BOC's compliance" with section 272, this "increases the likelihood that potential discrimination can be detected and penalized; this, in turn, decreases the danger that discrimination will occur in the first place." *Non-Accounting Safeguards Order* ¶ 243.

With these principles in mind, the Commission should therefore set forth additional standards and procedures to be applied to future biennial audits, including a re-audit of SBC and its section 272 affiliates. Such action is particularly critical because the General Standard Procedures that have been applied previously were never subject to public comment, but rather were developed for each audit in secret, allowing the BOC to negotiate the requirements to conform to whatever data they have decided to retain and which they view as not harmful. Basic precepts of administrative law require that the audit standards and procedures should be

developed through public participation and should be applied in a consistent manner from one audit to the next. At a minimum, the Commission should adopt the following guidelines.

First, the Commission should adopt binding rules that would require the audit to be publicly released in unredacted form within 90 days of the end of the audit period. The ability to make judgments about a BOC's post-entry conduct, and particularly its performance in providing special access and other key inputs into long distance services, is seriously undermined if the audit is not released promptly. Further, the deterrent effect of the audit is significantly strengthened where violations are quickly identified and penalized.

Second, the Commission should adopt a strong preference that the audit make a complete examination of the entire population of any transactions or data that the audit is assessing, rather than relying on sampling. *See* MCI Proposed Audit Comments, AAD-97-83, at 6 (filed Sept. 15, 1997). As these audits demonstrate, the use of any particular sampling technique is subject to significant dispute, and the results – particularly where insufficient information regarding the sampling is disclosed – are often inconclusive on issues that are central to section 272 compliance. And sampling by definition introduces risks that violations will go undetected. In the SBC and Verizon audits, sampling was performed even where a complete examination of all data would have been entirely practical (and, in some cases, was required by the *General Standard Procedures*).

Therefore, the Commission should adopt standards that address both when sampling is appropriate and that further define the specific sampling techniques to be used and the type of information that must be disclosed in the audit. In particular, the Commission should require that, where sampling is performed, enough information is provided (*i.e.*, such as standard

deviations and population sizes) to enable interested parties to determine if the data is statistically significant under various measures.

Third, the Commission should explicitly delineate the periods that should be audited, and require the BOC to maintain all relevant data for those periods so that the auditors can properly assess compliance with the section 272 obligations. Where the BOC fails to maintain or provide such data, the Commission should presume a violation of section 272. The Commission should thus clearly state all data that must be maintained and collected, and then broadly define the time period so that all possible discrimination can be detected (thus maximizing the deterrent value of the audit). Additionally, the Commission must make clear that, for a BOC's initial biennial audit, the auditors will examine all transactions and data since the formation of any 272 affiliate, including periods prior to section 271 approval. Most 272 affiliates begin providing interLATA service very soon after approval, and that necessarily requires that substantial activities between the BOC and those affiliates will occur prior to approval. If these periods are not audited, it would allow the BOC a significant opportunity to mask cross-subsidization and other cost misallocation.

Fourth, with respect to discriminatory conduct, the Commission should adopt the performance measures for special access proposed by the JCIG as well as other rigorous, well-defined, and properly disaggregated performance measures for other services like the PIC process. The JCIG measures are properly defined, apply a clear performance standard, and are subject to rigorous testing and open to interested parties. Use of such uniform measures would help to limit disputes during the process and to provide for consistent remedies where violations occur.

Fifth, the Commission should substantially strengthen a number of the standards in the existing guidelines. For example, the Commission should strengthen the standard to test compliance with section 272's requirement that a BOC provide certain inbound callers with information regarding their choice of providers for long distance service. As described above, under the current *General Standard Procedures*, the auditors need only observe 15 service representatives for 30 minutes each, with no requirement about the number of calls that must be monitored. This standard could never adequately determine if the BOC is complying with its obligation. Instead, the Commission should require that the auditors determine the scope of the entire population of relevant calls received, and then using proper sampling techniques observe a sufficient sample of calls to produce statistically significant results.

Sixth, the Commission should adopt guidelines for appropriate remedies and penalties for violations of the section 272 requirements. Such guidelines would help to ensure consistency, and would also aid in deterring violations, so long as the remedies and penalties were sufficiently strong.

Finally, in both of the audits that have been completed to date, even the limited data collected demonstrates that the BOCs have engaged in consistent and widespread violations of section 272 that must be remedied with appropriate penalties. Moreover, the substantial gaps and holes in the audit procedures also raise the possibility that these violations are representative of a greater pattern of cross-subsidization and discrimination against these BOCs' competitors. As a consequence, SBC and Verizon, and their affiliates, should immediately be audited again using more fulsome procedures.

CONCLUSION

For the reasons stated, the Commission should penalize SBC for its lack of compliance with section 272, and should immediately re-audit SBC using appropriate procedures and standards.

Respectfully submitted,

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January 29, 2003

CERTIFICATE OF SERVICE

I hereby certify that on this 29th day of January, 2003, I caused true and correct copies of the forgoing Comments of AT&T Corp. to be served on all parties by mailing, postage prepaid to their addresses listed on the attached service list.

Dated: January 29, 2003
Washington, D.C.

/s/ Peter M. Andros
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